professes to rely on market forces to bring the access rates towards costs. The market-based approach is designed to blend regulatory oversight and market forces in a three-tiered procedure that purports to reflect the extent of competition in the provision of exchange access. Under this approach, access rate levels would be left at their current inflated levels and access rate regulations would then be relaxed upon a showing of potential competition in the provision of access; regulatory oversight would be further reduced upon a showing of competitive presence in the provision of access; and, finally, regulatory oversight would be fully removed upon a showing of existing substantial competition. Because this approach would allow ILECs significant pricing freedom while they continue to possess substantial market power, it would be more aptly termed the "monopoly pricing" approach.

3. The Commission correctly recognizes that access reform is a necessary precondition for the implementation of the procompetitive goals embodied in the Telecommunications Act of 1996. The Commission also correctly suggests that access be priced on the basis of its forward-looking, long-run incremental cost. In this and related proceedings, this relevant economic cost has been defined as total service long-run incremental cost ("TSLRIC"), or its "element" variant total element long-run incremental cost ("TELRIC"). We agree with the Commission that access should be priced on the basis of such costs.

4. However, as set forth in this affidavit, the Commission's proposed "market-based" approach to access reform will not accomplish the procompetitive objectives of the Act. Indeed, it would exacerbate the existing distortions in the provision of access, increase -- rather than decrease -- access rates, and distort competition in the long distance market. This affidavit shows that the Commission's arguments against a "flash-cut" to access rates based on forward-looking, long-run economic costs are not persuasive. Accordingly, we

urge the Commission to require that long-distance access rates be set on the basis of TELRICs as soon as is possible and to defer further pricing flexibilities until actual constraining competition emerges.

I. THE PUBLIC INTEREST REQUIREMENT OF TELRIC-BASED RATES FOR NETWORK ELEMENTS.

5. In competitive markets, efficient prices emerge from vigorous competitive interactions among firms. In markets in which competition is nonexistent or ineffective, regulatory oversight is necessary to replicate those prices that would prevail if competitive pressures were effective. In these instances, setting rates at levels that would emerge in competitive markets will: (a) produce efficient allocation of resources by making consumers incur the actual cost of the goods they purchase; (b) send firms accurate signals regarding the profitability of entry (and exit); and (c) provide accurate signals for investments in new technology. By contrast, access rates based on embedded or book costs -- costs that would not be reflected in rates under fully competitive market conditions -- will distort consumer behavior and firms' investment decisions, and may also facilitate anticompetitive conduct. Thus, a regulatory system seeking to replicate the enormous benefits of competition should seek to replicate the rates resulting from an effectively competitive market.

6. By any measure, local exchange and exchange access markets are not competitive *today*, and thus, absent regulation, competitive access rates cannot be expected to result from any profit-maximizing, independent actions of the incumbent firms.[1] As set forth in our affidavits in the *Local Interconnection* proceeding, competitive market rates are based on

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[1] See B. Douglas Bernheim and Robert D. Willig, "The Scope of Competition in Telecommunications," Working Paper prepared for the American Enterprise Institute for Public Policy Research, October 25, 1996 (hereafter cited as "Bernheim & Willig, Competition"), Chapter 3.

forward-looking, long-run incremental costs. Forward-looking economic costs account for all the expenses required *today* to build and service the expected level of demand using currently available, cost-effective technology. These pertinent economic costs also include a return on capital sufficient to attract the requisite investments. Moreover, the pertinent economic costs are incremental because they must reflect the additional social costs that must be incurred to provide the various elements of the telecommunications network and the associated telecommunications services. Finally, the proper horizon for valuation of the relevant costs must be sufficiently long so that all the investments are recoverable within that time frame. This is so because the full costs -- including initial as well as recurring costs -- must be recovered over the anticipated lifetime of investments if they are warranted by anticipated levels of demand for their services.

7. In its *Local Interconnection Order* (CC Docket 96-98), the Commission recognized -- as did Congress in enacting the Telecommunications Act of 1996 -- that market forces do not effectively constrain ILECs' market power in the provision of local exchange services and unbundled network elements. In particular, certain network elements and facilities crucial to local interconnection and service remain exclusively within the control of these incumbent monopolists. This bottleneck in local telephony confers substantial market power on the ILECs and, in the absence of regulatory restraints, would allow the ILECs to price these network components significantly above their true economic costs. Absent an effective regulatory restraint, ILECs' competitors that have need for these monopolized elements would be required to pay rates substantially in excess of their long run, forward-looking economic cost. These excessive rates would not only increase the cost to consumers and distort usage and investment decisions, but could also stymie and distort any competition in the provision of local services, and potentially undermine and distort the

existing vigorous rivalry in the provision of long-distance services. Further, such excessive rates could facilitate anticompetitive price squeezes of ILEC rivals that weaken, distort or eliminate their ability to compete, and thereby further entrench ILECs, regardless of their relative efficiency, to their own profitability and to the detriment of consumers.

8. In its *Local Interconnection Order*, the Commission recognized that the ILECs can use their bottleneck inputs as a strategic tool to exercise, extend, and further entrench existing monopoly power. Recognizing also the dangers of the pricing of unbundled network elements (UNEs) on the basis of book or historical costs, and the contrasting benefits from the pricing of these elements on the basis of their true economic costs, the Commission embraced a forward-looking, economic cost method -- "Total Element Long-Run Incremental Cost" ("TELRIC"). By requiring states to prescribe rates using TELRIC, the Commission, in principle, removed the first obstacle to the emergence of competition in the provision of local exchange services.

9. However, despite the FCC's requirement that UNEs be priced efficiently, there is no reason to believe that UNE-based competition will emerge any time soon or that it will be sufficiently effective to constrain the ILECs' market power. Indeed, the ILECs have mounted a legal attack against the method adopted by the FCC.[2] And, furthermore in the states in which UNEs are in principle available at TELRIC-based rates, UNE-based competitors are in their nascency and there is no assurance that their offerings will be sufficiently acceptable to telecommunications customers to constrain incumbents competitively.

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[2] See Iowa Utilities Board, et al. v. FCC, No. 96-3321 (8th Cir.), Brief of Petitioners Regional Bell Companies and GTE, pp. 31-48 (filed Nov. 18, 1996).

II. THE NEED FOR TELRIC-BASED RATES FOR EXCHANGE ACCESS ELEMENTS.

10. As the Commission recognizes in the NPRM, interstate access is provided in the same manner and over the same facilities as local access. Transport and switching of a long distance call originating from a distant exchange is, from the standpoint of the network, the same as transport and switching of a call from within an exchange. In a competitive market, then, these services would be priced the same.

11. At the same time, the customer loop is used to access all types of telecommunications services, including local exchange and inter- and intraLATA toll services, as well as to terminate local and long-distance calls. Hence, it is impossible on any rational basis to allocate the costs of the loop among these various telecommunications services that the customer receives. In a competitive market, therefore, a loop's price would be based on the cost of its provision to the customer, irrespective of the customer's allocation of minutes of use among different services. Consequently, the cost of the loop -- or any portion thereof -- must be removed from the cost of exchange access.

12. The Commission has already recognized that the same network facility can be used to provide various telecommunications services. Thus, while the Commission has mandated that rates for unbundled network elements reflect the underlying TELRICs, the "recovery" of these long-run incremental costs should be based on principles of cost-causality. This means that, to the extent that different services and different levels of usage impose the same cost on the provider of the unbundled element, optimal economic efficiency requires that suppliers of these different services pay the same prices for the use of the element. There is no reason for the Commission to deviate from this precept in its determination of the appropriate rates for exchange access.

13. For the reasons stated by the Commission in its *Local Interconnection Order* as well as those in our affidavits in that proceeding, prices for exchange access elements must be set at forward-looking, long-run, incremental costs. Failure to reduce the currently distorted access rates to efficient levels will, in the first instance, continue to force consumers to pay billions of dollars annually in unnecessarily high long distance charges. This substantial wedge between price and social marginal cost not only transfers real income and purchasing power from consumers to ILECs. It also, inevitably, causes unnecessary and inefficient suppression of long distance calling, both in terms of minutes of usage that are demanded and calls that are placed that would generate value to consumers well in excess of the real costs that would be caused. In addition, the same excess in access prices can potentially do even more harm by fostering socially costly anticompetitive conduct by ILEC bottleneck holders.

14. A related socially harmful effect is that artificially inflated access rates will continue to send inaccurate market signals regarding the cost and profitability of exchange access and long distance services. As a consequence, incumbents may overbuild their networks, and potential entrants may invest their resources and deploy their facilities prematurely or out-of step with the growth and ever-changing nature of market demands. It is a general truth that distorted prices give inadequate guidance for socially desirable investment decisions, and it is plain that the extremely distorted current access prices give highly misleading signals to the continuing flood of proposed and implemented capital intensive projects in the telecommunications industry. This is the direct result of the wedge between access prices and costs, and would continue to be so unless the Commission embraces the TELRIC standard for access rates.

15. There are several important reasons why embedded costs do not constitute a

proper standard for the setting of access rates. First, there is no evidence that an ILEC would suffer a grievous revenue shortfall if access elements prices were based on TELRIC. But even if it would, any such recovery over and above forward-looking economic costs -- and it is far from clear that any recovery would be warranted -- should not be included in switched access charges.

16. In a competitive market, an asset's value is based on the future revenues it is expected to generate. The TELRIC principles adopted by the Commission replicate this stream of payments on an element-by-element basis. They reflect the economic costs, including a market-based return on capital, that an efficient entrant would encounter. In other words, TELRIC principles are fully compensatory of economic costs. Thus, the Commission should categorically deny additional recovery over and above forward-looking cost-based access rates to the extent that such recovery reflects overearnings, inefficiencies, misallocations, and overinvestment embedded in existing price cap levels. Nor should the ILECs be allowed to recover the costs of investments made to provide future services because those future services should be self-financing so that would constitute the kind of cross-subsidy that we have already identified as inimical to competition. If the Commission permits this recovery, it risks perpetuating the inefficiencies, distortions, and anticompetitive effects of the current access regime as well as forcing an unjustified transfer of wealth from consumers to the incumbent monopolists. The burden should be on the ILECs to demonstrate through clear and convincing evidence any sound public policy reasons why they should be permitted to charge prices for monopoly services that generate revenues in excess of forward-lookin economic costs. Otherwise, the best evidence clearly supports the proposition that a proper reinitialization of price cap levels to reflect TELRIC principles will provide the ILECs sufficient opportunity to continue earning a reasonable return on their

investments and future network enhancements. Most important, whatever the outcome of the debate over ILEC financial entitlements, it is crucial to the goals of the Commission and the goals expressed in the Act that genuine and undistorted competition be fostered by exchange access prices that are based on TELRICs, rather than on the non-competitive and inefficient regime of the past.

17. In any event, the Commission need not resolve in this proceeding the question whether ILECs should be entitled to recover in some fashion some portion of the net revenues from the provision of access that they will not earn because access will be priced on the basis of TSLRIC. This is a separate policy issue, and the process of resolving it should not be permitted to delay the institution of access reform in view of the significant social benefits it promises. In particular, a careful assessment must be made of any ILEC claims that sound public policy entitles them to recover any portion of the revenues lost as a result of cost-based prices for access.

18. As we have testified elsewhere, the pool of joint and common costs that would be unrecovered from prices that are literally equal to TELRICs is most likely quite small, *i.e.*, if one were to estimate total network-wide costs for an ILEC on a forward-looking, efficient basis, the needed mark-ups above TELRIC-based prices are likely to be quite modest. Thus, any shortfall between the sum total of revenues derived from TELRIC-based prices and the flow of embedded costs cannot be presumed to arise from scale and scope economies at the level of network elements that comprise exchange access. Moreover, if that shortfall is relatively large, it is unlikely to be a result of efficient common outlays, economies of scale or economies of scope.

19. This suggests the second reason why embedded costs are not an appropriate benchmark for the setting of access rates: these embedded costs potentially include

significant costs of continuing inefficiencies in operations. If access rates permitted the ILEC to recover the costs of inefficient operations, these inefficiencies would only be perpetuated. Such distortions in prices would reward past mistakes and could provide misleading and distorted signals to potential entrants. The goal of efficient regulation should be to stimulate entry when such entry is efficient and socially desirable and not to invite entry when it is profitable only because of rates distorted by inappropriate regulation that fosters inefficiencies.

20. The third reason why access rates should not reflect embedded costs is that the embedded cost base may include the investment costs of future, unregulated services. Such costs were expended -- rationally or not -- for services other than the regulated services built on the network elements and intended to be exposed to the advent of local exchange competition. Given the nature of the modern telecommunications network, the possibility that the embedded cost base includes such costs must be taken into consideration. In fact, investments in the network cannot be readily distinguished as between those that were, or are, made for the regulated services and those that were, or are, made for the competitive services of the future. This being so, basing network element prices, as well as the price of access, on these embedded costs is very likely to amount to a cross-subsidy of the ILECs' competitive offerings from their monopoly offerings. Such cross-subsidy would be particularly inimical to the achievement of the competitive objectives of the Telecommunications Act of 1996.

21. The competitive risks of such cross-subsidy are especially high because of the possibility that RBOCs will offer in-region, inter-LATA toll services -- as other ILECs, including GTE, already do -- as well as bundles of telecommunications services that include

local calling as well as long distance services.[3] Thus, ILECs will be competing with other carriers that will depend on the ILECs for the provision of terminating and originating access. In such a case, the anticompetitive effects of cross-subsidy are especially pernicious: the ILECs will be able not only to recover a portion of their investment costs by overcharging their rivals for access, but also to gain a strategic cost advantage. The source of that advantage is the difference between the true cost of access, as measured by its TSLRIC, and the distorted rate that the ILEC can charge to its competitors.

22. The opportunity for anticompetitive conduct in long-distance, therefore, is analogous to that in local services, except that it presents additional dangers. Telecommunications carriers will soon begin offering bundles of services that include local exchange access, and long distance services. The preference of many consumers for "one-stop" shopping will give those carriers that can provide this basket of goods less expensively a substantial market advantage. If exchange access prices are not based on TELRIC, the ILECs can use the cost differential between what their rivals pay them for these elements and the lower economic cost that they incur as a vertically integrated company to create an anti-competitive price squeeze, and artificially gain an advantage in the provision of bundled services. In this way, the ILECs can weaken their rivals in the supply of bundled, interexchange, and local services, build their own market power, sustain uncompetitive end-user prices, and disappoint hopes for an efficiently competitive marketplace. Both the

[3] RBOCs are already offering out-of-region, interLATA services in competition with the IXCs. There is a danger that even this competition will be compromised and distorted unless access rates are brought towards true economic costs. For example, NYNEX has been advertising per-minute rates from certain out-of-region states into its service territory that are lower than the per-minute rates from these states into non-NYNEX territory. It is difficult to explain this rate differential but by the fact that NYNEX does not "charge itself" fully for the costs of terminating traffic in its own local exchange territory.

incentives and the opportunities for such anticompetitive conduct are prevalent to an unfortunately high degree in telecommunications markets today.

23. The Commission has made real progress in the difficult process of opening local markets to competition, but if it fails to set access rates at economically efficient levels, it is likely to undermine dramatically the beneficial results of its recent actions. This is a very real danger throughout the interrelated domains of long distance, exchange access, and local markets.

III. THE "MARKET-BASED" APPROACH TO ACCESS REFORM.

24. It is undisputed that current exchange access prices are far above their economic costs. Indeed, the Commission itself recognizes this misalignment in the NPRM and has proposed two possible routes to reduction of exchange access rates to competitive levels. One attempts to utilize market forces while the other necessitates prescriptive action. Only the latter approach has any hope of success because, at present, market forces are incapable of constraining ILEC pricing of exchange access, and future developments in this situation are too uncertain to rely upon responsibly.

25. The Commission's "market-based" approach seeks to rely on emerging competition in the provision of local exchange services to break the ILEC monopoly on exchange access. It employs a three stage process with increasing regulatory flexibility as the power of market forces presumably increases, culminating in total deregulation of exchange access. Simply put, the "market-based" approach is based on the hope that exchange access will become effectively competitive. This approach should be rejected because (i) it is quite likely that this hope will not be fulfilled, and virtually certain that it will not be fulfilled rapidly; (ii) the consequences of reliance on competition that actually

does not exist in this domain are extremely threatening to the public interest; and (iii) these consequences include exacerbation of the impediments to the inauguration of the very competition that might otherwise, at some point in the future, justify deregulation of access pricing.

26. For decades most industry participants, regulators, and economists characterized the local network and exchange access as natural monopolies. A natural monopoly exists where the monopoly form of organization of production is most cost-efficient, generally as a result of economies of scale and scope. Where natural monopoly exists in a market with considerable demand, along with such economic entry barriers as those constituted by entrants' need to invest considerable sunk costs, an incumbent monopoly is likely to possess considerable market power and a consequent ability to charge profitable supracompetitive prices to the detriment of consumers. Regulation of natural monopoly industries undertakes to restrict the exercise of market power and to protect consumers, as it has historically attempted to do in markets for local exchange services.

27. More recently, recognition of the possibility that local and exchange access markets -- like long distance -- may perform well in the presence of competition has produced landmark legislative and regulatory reform. The Telecommunications Act of 1996 began the process of opening local markets to competitive carriers and, subsequently, in its Docket 96-98, the Commission adopted regulatory provisions designed to implement the procompetitive provisions of the Act and facilitate entry into these markets. Nevertheless, significant competition has yet to emerge.[4] Indeed, despite everyone's hopes, there is no sign that such competition will become ubiquitous in the foreseeable future. In fact, it is

[4] See Berheim & Willig, Competition, Ch. 3, pp. 55-81.

plausible that ubiquitous facilities-based competition in the provision of local exchange services may not be feasible, so that important areas of monopoly may persist. If this is indeed so, competition in the provision of local exchange services will have to rely on the ability of UNE-based local exchange carriers to constrain the ILECs' exercise of market power. And even if these hopes for ubiquitous, facilities-based competition will be realized, the Commission must nonetheless be sensitive to and heed the RBOC's history of hampering competition and the increased incentives they have in light of the Act's reforms to impede their rivals with renewed enthusiasm. Thus, Congress and the Commission have launched an admirable experiment, but one whose success, unfortunately, is not yet certain.

28. Exchange access competition can come from two sources, facilities-based and UNE-based entry. The prospects that carriers using either of these methods will be able to apply sufficient downward pricing pressure on access rates will be considered here. Unfortunately, neither seems likely to yield substantial competition for several years.

A. Facilities-Based Competition.

29. Facilities-based competition would be the most effective and direct method of constraining ILEC access pricing behavior. Unfortunately, it seems unlikely to emerge as a significant feature of local competition for at least several years. The most obvious barriers to this form of competition are the huge risks associated with investments in facilities, particularly the loop and transport facilities linking the customer to interconnecting carriers. For the most part, these required investments would be sunk, although some portion of set-up costs, like those required for acquiring switches, may remain fungible.

30. The initial sunk investment must be very large for any facilities-based CLEC targeting anything other than a very narrow segment of the market. Resale and UNE-based services to a certain extent can be provided to a small number of customers. However, the

minimum customer base for full-fledged facilities-based entry would be much larger as a result of the nature of the technology. Similarly, customers cannot be too geographically dispersed relative to their number or the required infrastructure would be prohibitively expensive.

31. Indeed, as the available evidence indicates, competitive access providers -- who are the ILECs' most direct competitors in the provision of access -- have focused their services on a small group of users located in very dense, urban areas. Although the number of lines offered by these vendors is growing fast, their share of installed lines remains insignificant compared to the lines served by the ILECs. And there is no evidence that these vendors have either the interest or the practical incentives to serve broad categories of residential and business users by means of their own facilities.[5]

32. New facilities-based competitors would face far greater risks than those experienced by the ILECs for several reasons, including the conduct of the incumbents. These added risks would both impose added capital costs on the CLECs were they to enter, and also discourage their entry in the first instance. First, the large-scale sunk set-up costs required of a new facilities-based CLEC are exposed necessarily to the risks of competition with the ILEC, while the ILEC's investments may not be exposed to such risks to the extent that facilities-based entry does not or is yet to occur. This is one of the fundamental causes of economic entry barriers. Second, if it were to turn out after facilities-based entry that competition in the local and exchange access markets were unsustainable, then the incumbent carrier would likely have a much better chance of regaining its monopoly position, while the new facilities-based competitor would likely be the one to fail and to lose a significant

[5] See Berheim & Willig, Competition, Ch. 3, pp. 7-17.

portion of its investment in the enterprise. Third, the risks facing a facilities-based entrant can be further increased through various business tactics of the ILEC. Such business tactics have already been demonstrated in several states where narrowly-focused facilities-based entry has been occurring.[6]

33. Thus, facilities-based competition may evolve only slowly and cautiously over time, with new entrants mixing-and-matching other forms of service provision, such as UNEs and resale, with their facilities. In light of these observations, if facilities-based entry ever evolves into an effective form of local competition, it is likely to do so initially in discrete pockets of densely populated areas, and only expand much later, if ever, to the rest of the customer population. We may also add that non-traditional alternatives -- such as cable or PCS -- are yet unproven as land-line substitutes, and therefore cannot be relied upon to offer effective competition to local services supplied by the traditional technology.

B. Resale And Unbundled Network Element-Based Competition.

34. Cognizant of the significant risks associated with facilities-based entry, the Telecommunications Act of 1996 also takes into account two other types of local exchange competition. First, the Act requires ILECs to offer their existing retail services for resale. This type of entry entails the least contribution of capital and the lowest level of risk. Resale competition does not, however, provide any constraint on the rates for exchange access, because a reseller is not entitled to collect originating or terminating access charges, which are retained by the underlying ILEC.

35. Second, the Act requires LECs to offer for sale unbundled network elements or collections of such elements. In contrast to resale, UNE-based entry gives CLECs at least

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[6] See Berheim & Willig, Competition, Ch. 3, pp. 62-69, 74-77, 79-81; Ch. 4, pp. 83-91.

some opportunity to compete in exchange access markets. However, UNE-based entry requires a much larger initial investment, and carries a significantly greater risk than does resale. For example, there is still a great deal of uncertainty regarding the pricing of unbundled elements. Of even-greater likely significance, there is a great deal of uncertainty about the treatment that CLECs and their customers will receive at the hands of the bottleneck-owning ILECs.[7] In sum, we expect that UNE-based entry is likely to occur only on a limited scale, while entrants solve the technical difficulties that will invariably arise and assess the relative profitability of this type of entry. It is just not clear how effectively UNE-based competition will constrain ILECs.

36. It is also important to note that, for regulatory reasons, UNE-based competition, to the extent that it emerges, will offer only a limited constraint on pricing of exchange access. The Commission's rules do not allow UNEs to be used solely for the provision of exchange access. Rather, a CLEC must "win" the local customer as a precondition to being able to provide local exchange access using the UNEs it has purchased from the ILEC. In this regard, CLECs differ from CAPs that specialize in the provision of access. The effect of the Commission's provision is that the effectiveness and magnitude of competition in the provision of access will significantly depend on the profitability of bundled entry into local exchange and exchange access markets, and not only on the profitability of providing

[7] For example, the ILEC can discriminate against the rival in the provision of high quality access; or it can select access technology that disadvantages the rival's offerings vis a vis those of the ILEC; the ILEC can be slow in provisioning loops and other UNEs required by the rival; and the ILEC can engage in various regulatory strategies designed to make entry into local markets more costly and risky. The consequence of these strategies is to make local exchange customers more reluctant to switch to the CLECs to the detriment of nascent competition envisaged by the Telecommunications Act of 1996. Consequently, it is no surprise that UNE-based competition is in its infancy and its efficacy has yet to be tested, much less proven, in the marketplace.

exchange access alone. The Commission then, has foreclosed direct exchange access competition from UNE-based CLECs and has, in the process, provided the incumbent monopolists with a market advantage. The Commission's limitation on the use of UNEs will, as a practical matter, necessitate that an entrant supply the customer with a basket of services -- local, exchange access, and long distance -- in order to obtain the customer at all. The ILEC, of course, does not face this *de facto* bundling requirement.

37. In assessing the extent to which competition can constrain exchange access rates, the Commission should also take into account the fact that a customer's choice of an access provider has an element of "externality" associated with it. This is so because a customer originating a call pays for terminating access, yet cannot directly affect the choice of the terminating carrier at the called party's end. As a result, the originating customer has no direct way of inducing the receiving customer to select an efficiently inexpensive terminating carrier. Stated another way, whether or not the behavior of customers permits viability of access arrangements depends on their economic incentives. Because the caller pays for terminating access, the development of access arrangements for switched traffic will be driven by the resulting cost effect only on outgoing calls (originating access). No individual has an economic incentive to consider the effect on the costs of incoming calls (terminating access). This externality problem is another reason why market forces cannot be relied upon today, nor in the clearly foreseeable future, to discipline access prices effectively to competitive levels. This problem is particularly severe because the ILECs currently control almost 100 percent of the local market and over 99 percent of exchange access revenues. Thus, even if UNEs someday become the foundation for vigorous rivalry, and even if someday the Commission lifts its ban on their use to supply discrete exchange access, this externality will nevertheless continue to limit their constraining force on access

prices.

38. Setting all these considerations aside, an additional shortcoming of the Commission's "market-based" approach to access rate reform is that it offers no concrete guidance as to the metric that the Commission will use to gauge the intensity of competition in the local market. We must emphasize that reliance on potential competition, where there is little reason to believe in its reality and effectiveness in replacing regulatory oversight over access rates, would harm consumers and distort competition in local and toll markets.

IV. THE "REINITIALIZATION" APPROACH TO ACCESS REFORM.

39. With no near-term possibility that market forces will reduce exchange access prices to their forward-looking economic costs, the Commission should take immediate steps to reinitialize the price cap levels to reflect TELRIC-based rates for access elements. Adjusting the price caps now to reflect efficient rate levels achieves the benefits of exchange access competition immediately without the substantial transitional costs associated with the "market-based" approach. Reinitialization measures will not only eliminate the billions of dollars unnecessarily transferred from access customers to the ILECs and eliminate the various market distortions discussed above, it will also allow the Commission to retain its regulatory flexibility and will foster efficient and effective local exchange and exchange access competition.

40. By not relaxing the regulatory constraints on exchange access, the Commission will have sufficient time to ensure that competition sufficiently constrains ILEC pricing behavior. When and if competition has been clearly shown to constitute a substantial pricing constraint the relevant exchange access markets, the Commission can relax and eventually eliminate price cap regulations as appropriate. With the sweeping changes about to occur

in the telecommunications industry, the Commission may find that the particular regulations it believes should be eliminated today are in fact essential to maintaining pricing efficiency and fostering competitive entry, while other regulations it currently has identified as important may be unnecessary. Tailoring regulatory flexibility to the actual competitive conditions that emerge is far more practical and far less prone to error that devising a formulaic approach to regulatory flexibility based on a checklist of unproven criteria, or worse, on hopes for competition rather than on its reality.

41. Premature regulatory flexibility also risks substantial harm to competition. As discussed above, when exchange access prices are unnecessarily above their economic costs, an incumbent monopolist has an added ability to engage in an anti-competitive price squeeze and discriminate against other carriers and in favor of its long distance affiliate. In addition, excessive rates facilitate the ILEC's ability to offer a bundle of local, exchange access, and long distance services at a price that an efficient CLEC cannot match, thereby risking extention of the incumbent's bottleneck control into the creation of market power in other markets. Even though price cap regulation may function in a noncompetitive market, if the price cap has not been reinitialized to reflect TELRIC principles, that noncompetitive market can be used to subsidize the ILEC's telecommunications services in a competitive market, and distort and undermine the competition that might otherwise serve the public. A TELRIC-based price cap significantly reduces these possibilities.

42. In addition to the effects already discussed, it should be emphasized that continuing supracompetitive rates for exchange access create powerful incentives for an ILEC to engage in anticompetitive behavior. Under current rates, the ILECs earn billions of dollars above costs from exchange access services. ILECs will retain these rents only insofar as entrants fail to serve local customers through UNEs or the entrants' own facilities.

Consequently, to the extent there would otherwise be any real possibility of effective UNE-based or facilities-based competition, the rents created by the excessive access rates would generate sharp incentives for the ILECs to attempt to protect them with anticompetitive behavior. These incentives would encourage the ILECs to engage in additional litigation in order further to delay entry or obtain higher UNE rates. Protection of exchange access rents would also motivate ILECs to provide degraded quality and inferior service to CLECs and their customers dependent on ILEC bottlenecks. While ILECs may expect some penalties for such conduct, the additional exchange access rents this conduct might secure may well offset this risk. Indeed, if potential entrants were to believe that such anticompetitive practices would be sufficiently prevalent and difficult to overcome, they might simply choose not to enter at all.

43. The possibility of abuse of the exchange access bottleneck is as dangerous as any other issue now confronting the industry. Hence, the competitive threshold for its deregulation must be adjudged with appropriate caution and attention to the public interest, with superficially attractive shortcuts deliberately foresworn. Although it is impossible to predict at this early stage when the levels of unbundled network element and facilities-based competition will become sufficient for access-price market discipline to supplant price caps appropriately, it cannot be overstated that the costs associated with premature reliance on market forces are enormous, and that the Commission should therefore proceed with caution and only upon clear and convincing evidence of actual and adequate demand and supply responsiveness. Competition does not exist yet, and the Commission should not be pressured into imagining it.

44. The fundamental shortcoming of the "market-based" approach is that it places the cart before the horse. Local competition is not the key to exchange access competition;

rather, exchange access is an essential ingredient for local competition and the continuation of long distance competition. Once facilities-based competition becomes ubiquitous, and evidence has accumulated that the local market can sustain multiple carriers with significant market share or easily prospective reach, then the Commission can consider the prudence of taking the last step and deregulating exchange access. Competition may eventually provide sufficient discipline for local services, but it does not even come close today. Similarly, competition may ultimately constrain ILECs in exchange access pricing, but that date remains somewhere in the distant and cloudy future. The Commission should follow its own example and prescribe TELRIC-based rates for exchange access just as it did for other network elements in Docket 96-98.

V. THE RECOVERY OF COSTS OF LOOPS AND OTHER FACILITIES DEDICATED TO A PARTICULAR END USER.

45. The most efficient and logical source of cost recovery for loops and other facilities dedicated to a particular end user is the cost-causing end user. The current system of access charges, on the other hand, is needlessly elaborate, imposes high transaction costs, misleads customers, distorts and represses usage, and discourages carriers from competing for low-volume customers.

46. The current access regime recovers portions of loop costs through per-minute carrier charges, even though the cost of the loop is caused by the end user, not any particular telecommunications service, and is fixed and invariant to the number of minutes of usage. This misalignment is socially harmful, and entirely unnecessary going forward. The needlessly large and artificially variable carrier charges are inevitably passed along to interexchange customers in the form of needlessly high prices. These significantly repress calling activity and durations, to the loss of consumer value and social real income. At the

same time, if the genuine economic costs of loop services were reflected in prices for loop services, rather than inappropriately reflected in carrier charges, then most customers would face efficient incentives to make decisions about their network access arrangements.[8]

47. The Commission's obligation to encourage effective and well-functioning competition is also inconsistent with the recovery of loop costs through artificial, usage-sensitive carrier fees. Under a system of artificially inflated usage charges, high volume users generate more excess earnings, while low volume customers generate less or none. Consequently, to the extent that high access fees attract entrants at all, they will focus their efforts on high volume consumers, leaving the market for low volume customers uncontested.

48. Transfer of the loop costs from inefficient carrier-usage fees to a fixed end-user charge will eliminate all these inefficiencies and any difficulties associated with arbitrary and costly exercise of allocating portions of the loop among local, exchange access, and long distance services. At the same time, this transfer of charges does not mean that the absolute amount of loop costs directly borne by the end-user must rise. The realignment to true forward-looking economic costs, instead of embedded or historical accounting costs, may actually reduce the total loop charge, while helping to rationalize telephone usage, fostering genuine competition, and reducing the social damage caused by the current access regime.

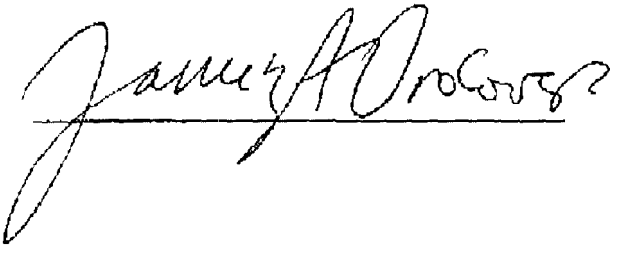
[8] It is the Universal Service Fund that should be relied upon to solve the problems, in a competitively neutral manner, that arise from the special circumstances where loops engender unusually high levels of costs, and where households cannot afford to pay network access costs.

DECLARATION

I, William J. Baumol, declare under penalty of perjury that the foregoing is true and correct. Executed on January 29, 1997.

DECLARATION

I, Janusz A. Ordover, declare under penalty of perjury that the foregoing is true and correct. Executed on January 27, 1997.



DECLARATION

I, Robert D. Willig, declare under penalty of perjury that the foregoing is true and correct. Executed on January 28 1997.

Robert Willig